

## EQUITY INVESTMENT OUTLOOK

February 5, 2010

Coming into the new year, the All-Cap Core portfolio was positioned for cyclical recovery. While we still believe this is likely to be the most attractive way to achieve risk-adjusted returns, a few macroeconomic events have transpired which lead us to conclude that a reduction in the portfolio's risk profile is warranted. We have also noted a recent lack of positive follow-through in stock prices to good fundamental earnings reports, which can sometimes be indicative of a "tired" market. As a result we have tactically added some short and ultrashort ETFs to the portfolio to reduce the overall market exposure, and have also trimmed our allocation to the energy, materials and financial sectors. On balance we believe that the momentum of the business cycle is likely to carry stocks higher, but our enthusiasm has been tempered slightly.

During January, China's leadership made very public statements about reducing the amount of liquidity in their economy, principally by asking banks to restrain credit. While this may be a prudent response to what has been a very successful stimulus program to date, it nevertheless has the potential to at least marginally reduce global growth since China is such an enormous consumer of both commodities and finished goods.

In addition, there are growing concerns that Greece's fiscal problems may be so profound that it will have to default on its sovereign debt and/or be bailed out financially by the European Union. Recently, credit spreads have widened significantly, reflecting this concern on the part of investors. Also of concern are other fiscally-challenged nations in the EU, including Portugal, Spain, Italy, and Ireland, and what actions might follow a possible default/bailout of Greece.

While the Greek situation is an issue of concern, perhaps more realistic than an outright sovereign default is that the current situation highlights structural deficiencies of the Euro currency. Other countries in Europe with fiscal challenges are likely to add to pressures on the Euro, and these events conspire to strengthen the US dollar. Already the dollar is stronger than it has been since the middle of 2009. To the extent that investors were engaged in a carry trade involving weak US dollar and strong Euro or other currencies or commodities, the trends on which this trade was based have at least temporarily been broken, severely pressuring commodities. As a result of this counter-trend rally in the dollar and China's policy shift, we have eliminated our exposure to the gold mining stocks as well as some of our other commodity-oriented holdings.

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It is logical to reason that at some point in the next 12-24 months, the US and other governments around the world will begin the process of withdrawing the massive stimulus programs that were put in place last year to avert a meltdown of the financial system. An upcoming example is the March expiration of the Fed's support of the mortgage-backed securities market, also known as the TALF program. The expiration date was already extended once, but for now it seems likely that it will end in March. This begs the question of what will happen with mortgage rates once the Fed backs away, and the market response may provide important clues as to whether the US economy is ready for this withdrawal of liquidity. On the margin, concerns regarding liquidity withdrawal have also contributed to our decision to increase the risk tool weighting in the portfolio.

Finally, in recent weeks the Obama administration has brought financial regulation to the forefront of its agenda. Possible legislation may include new taxes, stricter capital limits and the prohibition of proprietary trading and investing activity. The proposed "Volcker Rule" would prohibit banks from engaging in proprietary trading, private equity, and hedge funds. While many banks would not be severely impacted by this rule, some investment banks do engage in these activities from time to time. As a result of this more acute regulatory/political environment, we have dramatically reduced our exposure to investment banks in the portfolio.

Despite these issues, evidence abounds that the economic recovery continues. The recent US GDP report was even more robust than had been anticipated, and the World Bank raised its outlook for global growth. Surveys of capital spending plans indicate a surge in orders for equipment, which historically often accompanies hiring. This survey data is confirmed by the multitude of companies reporting their fourth quarter results and discussing their 2010 capital spending plans, and also by the likes of Cisco Systems speaking about the extraordinary growth that company is seeing in its order book. Consumer sentiment indicators continued to rise, as did personal income levels and consumer spending, the latter confirmed by strong January retail sales figures reported over the past week. While we would still like to see improvement in the reported employment data, the trend is still pointing towards improvement, and it is possible that we may see jobs being added as early as next month. Nevertheless, we have increased our use of risk mitigation tools for the time being because of the potential for global contagion from the Greek debt concerns and the possible negative impact of the withdrawal of liquidity by the Fed and the Chinese banking authorities.

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